

Report on Interested Parties Meeting
Revenue and Taxation Code §19138(b)
Large Corporate Understatement Penalty
December 5, 2008

Administration

The interested parties meeting was held on December 5, 2008, at 10:00 a.m., at the Franchise Tax Board office in Sacramento. Approximately 50 individuals attended in person and by telephone. Representing the department were Bruce Langston, Douglas Powers, and Anne Mazur of the Legal Division and Jeanne Harriman of the Audit Division.

Background

Revenue and Taxation Code section 19138 was added by SB X1 28 (Stats. 2008, 1st Ex. Sess. 2008, Ch. 1), and is effective December 22, 2008. This statute created a new penalty that applies to corporations for taxable years beginning on or after January 1, 2003, where the corporation has an understatement of tax in excess of \$1 million. The penalty is 20% of the understatement, which is measured by the difference between correct amount of tax and the tax reported on the original return or on an amended return filed on or before the extended due date.

For the 2003-2007 taxable years, a taxpayer can file an amended return and pay the tax shown on the amended return by May 31, 2009, in order to treat the tax shown on this amended return as tax shown on the original return for purposes of the penalty. This action will increase the taxpayer's self-assessed tax base against which the understatement is measured to reduce the likelihood of receiving this penalty for the 2003-2007 taxable years.

The purpose of the interested parties meeting was to elicit public input regarding the penalty including issues related to payments and the filing of amended returns by May 31, 2009, pursuant to Revenue and Taxation Code section 19138(b).

Staff Commentary

FTB staff opened the meeting by describing the new statute and stating its understanding that the purpose is not primarily to raise revenue from the penalty itself, but to change taxpayer behavior to encourage the filing of more accurate original returns. Staff stated the "cure" provision for the 2003-2007 taxable years provided in §19138(b) is designed to allow taxpayers to make an affirmative self-assessment to correct income, deductions, or credits that were misstated on the original return. This action would have the effect of increasing the penalty base during the cure period as if those amounts were correctly shown on the original return.

It is not staff's belief that the goal of the new statute is for taxpayers to make payments of amounts they do not believe they owe or manipulate the figures on an amended return to avoid a future penalty.

Staff believes that the new statute is modeled loosely on the substantial understatement penalty, and the definitions provided in IRC §6664. The underlying regulations relating to qualified amended returns provide guidance as to how §19138(b) returns should be prepared and filed.

Staff also stated that the term "amended return" in normal tax administration means a formal return that is sufficiently detailed that it can be determined what item of income, deduction, or credit is being adjusted. To be valid and effective to increase the penalty base under §19138(b), the return must meet the traditional standard of good faith and a reasonable attempt to comply with the tax laws.

Legislative staff commented that the intent of the bill enacting §19138 (authored by the Senate Committee on Budget and Fiscal Review) appeared to be to encourage the filing of a more correct return by taxpayers and to raise revenue, and that the bill had not been the subject of a hearing in the tax policy committees.

Attendee Commentary

Representatives of major corporations, law firms, and accounting firms attended the meeting. They expressed, in writing and orally, the following questions, concerns, and recommendations:

- The sole purpose of enacting this new penalty, for which there was no opportunity for public vetting, was to accelerate revenue. In this down economy, the penalty is contrary to any economic stimulus and is simply short-term borrowing.
- FTB should seek complete repeal or substantial revision of the penalty statute. If not complete repeal, the penalty should be repealed for the taxable years beginning on or after 2008. The statute should be revised to clarify what is required on amended returns with respect to the cure provision.
- The penalty threshold should include a percentage of liability shown on the original return as an alternate to the \$1 million threshold. A relatively low fixed dollar amount threshold may not be appropriate for taxpayers with annual California tax liabilities in the hundreds of millions of dollars. Large taxpayers view the \$1 million threshold as unfair because there is much narrower room for error for a \$150 million taxpayer than a \$3 million taxpayer. Thus, the statute should be amended to provide that the threshold be the greater of \$1 million or a percentage of the liability reflected on the original return.
- Taxpayers do not and cannot know the full extent of future adjustments to their final tax liability for a taxable year.

- What is the required level of specificity on an amended return filed under §19138(b)? Concerns exist on what the department considers an acceptable level of specificity when identifying the basis for additional tax on an amended return. Because taxpayers cannot know the full extent of future adjustments to their final tax liability, FTB should accept amended returns with a "protective payment" designated as filed and paid solely for purposes of avoiding this penalty, with limited information on the return, with language such as the following: the additional self-assessed tax is "due to unknown federal and/or CA adjustments" or "for purposes of avoiding the §19138 penalty." Similar methods should be allowed for original returns as well.
- Related claims for refund should be allowed to be filed on the sole basis that "amounts previously paid were for unknown federal and/or CA adjustments" or for the "§19138(b) amount," which would require FTB to refund such amounts unless FTB establishes adjustments that increase the liability.
- Qualify the amended and/or original return jurat to allow for "...the impossibility of accurately predicting the ultimate tax liability, and accordingly the taxpayer does not believe that the tax liability as amended herein is correct." If the jurat is not qualified, how can taxpayers file under penalty of perjury what they believe to be an incorrect position? Will related penalties apply?
- Add a separate line to original or amended returns to allow reporting of additional amounts for purposes of reducing exposure to the penalty.
- Allow tax deposits: The department could allow such protective payments or pre-payments to offset any future understatements that may be subject to the penalty; thus satisfying the intent to accelerate income without requiring intentional inaccurate reporting in order to avoid the penalty.
- Interpret the "change in law" exception broadly to include adjustments made under §25137, and for FTB and IRS notices that identify a change in policy, IRS private letter rulings, both federal and state statutes, and federal and state regulatory changes. Issue an announcement providing a list of those actions that the department considers a "change in law" for each applicable taxable year for purposes of this exception to the penalty. Issue such an announcement for the 2003-2007 taxable years prior to the amended return due date of May 31, 2009, to allow taxpayers to determine whether potential understatements are attributable to a change in law.
- The volume of requests for Chief Counsel Rulings is expected to increase due to this penalty. How will FTB handle such situations where a Chief Counsel Ruling request has been made but no ruling is issued by the due date for filing a return?

- File original returns calculating the tax using the most conservative positions. Then file a claim for refund with a more aggressive stance on matters reflected on the original return. Taxpayers could use this same approach when filing amended returns for 2003-2007 by May 31, 2009, to avoid the penalty.
- California returns filed in a manner to reduce exposure to the penalty will be inconsistent with federal and other state returns.
- Will there be any relief for underpayment of estimated tax penalties for 2008?
- Will amended returns be required with respect to the 2003-2007 tax years where assessments are paid and final, or where assessments are in dispute?

Summary of Issues

The primary controversy expressed in the meeting with respect to the administration of the "cure" provision of the penalty for the 2003-2007 taxable years is how detailed the amended return must be to satisfy §19138(b). In order to administer the program, the department needs to be able to process the returns with accepted values for deductions, income, credits, and tax liability so that subsequent adjustments have a clear starting point. Meeting attendees are concerned that they will be unable to determine what adjustments might be made in the future and, therefore, will be unable to file an accurate and complete amended return before the deadline. Attendees question the department's interpretation of the legislative intent behind the amended return requirement and suggest that the statute can be interpreted to allow amended returns that do not specify amounts of income or deduction. Attendees suggest the problem will exist as well for original returns filed for later years.

Subsequent Action

At the conclusion of the meeting, staff reiterated its interest in hearing and receiving additional comments, and agreed to provide guidance to the extent possible in January 2009. Staff will invite public comment on the FAQs as they are posted on the department's website. Comments will be considered in subsequent guidance.